1-1-1982

Sunset review of accounting principles : report

American Institute of Certified Public Accountants. Division for CPA Firms. Technical Issues Committee

Technical Issues Committee Report
Private Companies Practice Section
AICPA Division for CPA Firms

SUNSET REVIEW OF ACCOUNTING PRINCIPLES

This report represents the considered opinion of the technical issues committee of the AICPA Private Companies Practice Section. One of the section's objectives is to "provide a better means for member firms to make known their views on professional matters, including the establishment of technical standards." It does not represent an official position of the Institute. The report has been submitted to the AICPA Special Committee on Accounting Standards Overload.

Technical Issues Committee Report
Private Companies Practice Section
AICPA Division for CPA Firms

SUNSET REVIEW OF ACCOUNTING PRINCIPLES

1211 Avenue of the Americas, New York, N.Y. 10036-8775
1 2 3 4 5 6 7 8 9 0 PCPS 8 9 8 7 6 5 4 3 2

Introduction

In 1980 the technical issues committee of the AICPA Private Companies Practice Section began a project to identify significant measurement and disclosure requirements of generally accepted accounting principles that either (*a*) are not relevant to the financial statements of most small and medium-sized privately owned businesses (private companies) or (*b*) do not provide benefits to the users of those statements sufficient to justify the costs of applying the principles. The requirements that, in our opinion, meet either of these criteria are cited in this report.

We recognize that considerable study, evaluation, and debate precede every GAAP pronouncement. However, we have the benefit of hindsight gained through the experience of working with those pronouncements. Our conclusions are based on that experience. Our perspective is that of a committee composed of practicing CPAs who serve private companies and who know the needs of those companies and their owners and creditors. We therefore did not conduct formal surveys or other studies into the costs and effects of particular requirements.

In early 1981, the AICPA appointed a special committee to consider alternative means of dealing with accounting standards overload. On December 23, 1981, that committee released a discussion paper setting forth its tentative conclusions and recommendations, including a discussion of the question of "two sets of GAAP." The paper also recommends that the FASB reconsider certain accounting standards. Although our study, done independently, had a different objective, some of our recommendations address the same issues discussed by the special committee. The special committee may therefore find our recommendations helpful as it forms its final conclusions.

This report presents our findings and recommendations. We believe the AICPA Special Committee on Accounting Standards Overload, the Financial Accounting Standards Board, and others should consider and act on these recommendations promptly. We urge other groups and individuals who are interested in, or who can influence, the establishment of accounting standards for private companies to join us in recommending prompt action.

We believe that the FASB and its predecessors did not give adequate consideration to the needs of private companies before issuing certain standards. Many of our recommendations address this inadequacy. In the future, the FASB should, to a far greater degree than in the past, consider, measure, and evaluate the possible effects of its pronouncements on private companies and their accountants to ensure that accounting standards are relevant and cost-effective for all companies.

In evaluating GAAP requirements, we considered only their impact on private companies and the CPAs who serve them. This is the area of our particular interest and expertise and the area most in need of relief. It might be desirable to apply our recommendations to all companies, but we did not study this possibility. We do not believe, however, that exempting private companies from accounting standards that are not relevant or cost-effective for them is the same as establishing two sets of GAAP.

The remainder of this report discusses the specific GAAP requirements that we believe either should not apply to private companies or do not sufficiently benefit the users of private companies' financial statements to justify their costs. In each case, we recommend a particular change needed to provide immediate relief. The recommendations are referenced to volumes 3 and 4 of the looseleaf editions of *AICPA Professional Standards* published by Commerce Clearing House. In order to implement some of our recommendations it will be necessary to make conforming changes to other sections of the authoritative literature; our report does not deal with these secondary issues.

These are the issues addressed in this report:

Issues and Recommendations

Deferred Income Taxes

Private companies should not be required to comply with the requirements of APB Opinion no. 11 related to interperiod tax allocation. As an optional alternative to the requirements of APB Opinion no. 11, private companies should be permitted to reflect in their financial statements the taxes actually incurred or the tax benefit actually obtained, as reflected in the entity's income tax return. The taxes incurred during the period would appear in the income statement as a tax provision (or credit), and the amount owed at the close of the period would appear in the balance sheet as a liability (or as a receivable or prepaid expense). Disclosure of accounting and tax treatments that differ substantially (for example, real estate sales, depreciation, lease revenue) should be required.

This recommended method of accounting for income taxes would provide effective relief from the severe practical problems created by current requirements without misleading users. It is simple to apply and thus avoids the costly and burdensome record-keeping and calculations now required to determine a deferral that is not a real liability and is not understood by users of financial statements.

Because it provides the information needed by users in a form that is readily understood, it increases the usefulness of financial statements. It recognizes — far more realistically than does APB Opinion no. 11 — that tax regulations and effective rates change frequently because of Internal Revenue Code changes and fluctuations within the normal tax bracket. It is consistent (which APB Opinion no. 11 is not) with the definition of liabilities contained in FASB Statement of Financial Accounting Concepts no. 3. More effectively than its alternatives, it results in financial statements that reflect economic reality. Finally, it is preferable to the "liability method," which would provide only a small measure of relief from some of the calculations and record-keeping now required.

Recommendation. *Revise AC sec. 4091 to permit a private company to reflect in its financial statements the taxes actually incurred or the tax benefit actually obtained, consistent with its income tax return.*

Leases

Private companies need relief from the complex, burdensome requirements of FASB Statement of Financial Accounting Standards no. 13 and its seven amendments and six interpretations. No other authoritative accounting pronouncements (with the possible exception of pronouncements requiring deferred tax accounting) are as vehemently criticized by private companies and the CPAs who serve those companies.

SFAS no. 13 appears to have been written mainly with large, publicly held companies in mind. While leasing is an important aspect of the operations of small private companies, SFAS no. 13 has clearly gone beyond the needs of the users of these companies' financial statements.

SFAS no. 13 and its amendments and interpretations are not relevant to or cost-beneficial for private companies for the following reasons:

1. The users often do not understand the accounting treatment or the footnote disclosures required by the statement. (This is borne out by the FASB's own research.) Thus, additional accounting fees are required for explanation of the financial statements to users.
2. Lease agreements are often structured to avoid the need to capitalize the leased property. Experience indicates that this

will happen no matter how detailed and specific the accounting requirements are. An accounting standard that is so frequently avoided is fatally flawed.

3. When reporting for income tax purposes is different from that required by the statement, two sets of records for leases must be maintained. This is particularly burdensome to a company in the business of leasing property and equipment.

In addition, considerable latitude still remains in determining the classification of a lease. Examples are (*a*) estimated economic life of leased property, (*b*) bargain purchase option, (*c*) estimated residual value of leased property, and (*d*) lessee's incremental borrowing rate. The objective of narrowing differences in practice is not achieved, because a lease that would otherwise be capitalized can be structured as an operating lease even under (or in spite of) the present complex pronouncement and interpretations.

Recommendation. *Exempt private companies from AC sec. 4053. Full disclosure of lease obligations should be adequate to meet the needs of the users of private companies' financial statements. If it is determined that disclosure is not adequate, then the accountant should determine, based on his professional judgment, whether the lease should be capitalized.*

Capitalization of Interest

Private companies should not be required to capitalize interest costs on either assets they produce for their own use or assets intended for sale or lease, as required by SFAS no. 34.

The accounting and administrative cost to private companies of capitalizing interest or of considering whether capitalization is necessary exceeds the benefit it provides. As indicated in Appendix A of SFAS no. 34, accounting for interest has been the subject of discussion since the turn of the century. Action was taken by the FASB not because agreement was finally reached on all the broad conceptual issues (there is no such agreement), but because the SEC strongly implied that the FASB should develop "systematic criteria as to when, if ever, capitalization of interest is desirable." Given that background, it would have been entirely appropriate for the board to have exempted all private companies from any requirement to capitalize interest, just as it decided that interest should not be added to the cost of certain inventories.

Recommendation. *Rescind the applicability to private companies of AC sec. 5155, which requires capitalization of interest on certain assets produced for an enterprise's own use or for sale or lease.*

Imputed Interest

Private companies should not be required to impute interest on receivables and payables as required by APB Opinion no. 21.

Interest imputation can be misleading, since for private companies it often does not reflect the intent of the parties as they perceive it. It imposes an unnecessary burden on private companies and their CPAs, complicates retrieval of useful information from a private company's primary books and records, and is often confusing to those who use the financial statements.

Recommendation. *Rescind the applicability to private companies of AC sec. 4111, which requires the imputation of interest.*

Compensated Absences

Private companies should not be required to accrue a liability for prospective compensated absences that accumulate but do not vest as required by SFAS no. 43. The liability for prospective compensated absences should recognize only those amounts that employees would be paid if their employment terminated.

Relief from this requirement is needed particularly by private companies, for which the cost of accumulating the necessary information is especially burdensome.

When employers voluntarily pay employee compensation that they are not obligated to provide, the cost is appropriately a charge to the periods in which the compensation is paid. Those periods — and possibly subsequent ones — are the only periods that benefit from the employee compensation payments.

Recommendation. *Rescind the applicability to private companies of the words "or accumulate" in AC sec. 4066.06b.*

Business Combinations

Private companies should not be required to include in notes to the financial statements the pro forma results of combined operations as required for purchase accounting by APB Opinion no. 16.

A requirement for disclosing in the financial statements of private companies the pro forma results of operations for the current and preceding periods is unnecessary. Those who might reasonably be expected to have an interest in such information are likely either to have seen the individual financial statements of the combining entities or to be in a position to require the preparation of the pro forma information.

In addition to being unnecessary, this requirement is costly to private companies and their CPAs, particularly when the combining entities have different fiscal years.

Recommendation. *Rescind the applicability to private companies of AC sec. 1091.96, which requires that, for the year in which a business combination occurs that is accounted for by the purchase method, notes to the financial statements of the acquiring corporation include pro forma results of past operations.*

Troubled Debt Restructurings

Private companies (other than financial institutions) should not be required to disclose the interest income that would have been recorded under the original terms of restructured troubled debts, as is currently required by SFAS no. 15.

The information provided by these disclosures is of little or no value to issuers or third-party users of private companies' financial statements. Therefore, the cost of developing and presenting the information is unnecessary.

Recommendation. *Rescind the applicability to private companies other than financial institutions of AC sec. 5363.040a(ii) and (iii).*

Research and Development Costs

Private companies should not be required to disclose the total research and development costs charged to expense as required by SFAS no. 2.

Many private companies control and report their expenses by natural expense category. Determining which and how much of those expenses represents research and development is costly and unnecessary. The resulting data can be misleading since they are often based on arbitrary estimates and allocations.

Recommendation. *Rescind the applicability to private companies of AC sec. 4211.13 and .14.*

Discontinued Operations

Private companies should not be subject to the reporting requirements concerning discontinued operations that are specified in APB Opinion no. 30.

These requirements are burdensome and costly, and the information ordinarily is not important to the users of a private company's financial statements. Users should be made aware through disclosure that a segment has been or is to be discontinued. If the information is then considered necessary or helpful, it can be requested, and the request can be considered in relation to the cost. It is wasteful to impose the requirements in the many circumstances where they are neither needed nor wanted.

Recommendation. *Exempt private companies from the requirements of AC sec. 2012.08 through .18.*

Tax Benefit of Operating Loss Carryforward

Private companies should not be required to report as an extraordinary item the tax benefit of an operating loss carryforward as required by APB Opinion no. 11.

The users of the financial statements of private companies are adequately informed of the tax benefits of an operating loss carryforward through the disclosures required by paragraph 63 of APB Opinion no. 11 (AC sec. 4091.62). Therefore, classifying this as an extraordinary item adds unnecessary cost and confusion.

Recommendation. *Rescind the applicability to private companies of AC sec. 4091.44 and .60.*

Investment Tax Credit

Private companies should not be required to disclose the method of accounting for the investment tax credit as required by APB Opinion nos. 2 and 4. The disclosure is simply unnecessary. Virtually all private companies use the flow-through method.

Recommendation. *Amend AC sec. 4094.18 so that a private company will be required to disclose its method only when it uses a method other than flow-through.*

Technical Issues Committee (1981-82)
AICPA Private Companies Practice Section
Division for CPA Firms

Sandra A. Suran, *Chairman*	Suran & Company, Portland, Oreg.
James Castellano	Rubin Brown Gornstein & Co., St. Louis, Mo.
Donald M. Dale	Goodman & Company, Norfolk, Va.
Steven N. Fischer	Urbach Kahn & Werlin PC, Albany, N.Y.
Paul J. Fouts, Jr.	Finn & Company, Indianapolis, Ind.
Earl D. Harriman	Windes & McClaughry AC, Long Beach, Calif.
Michael W. Houston	Mauldin & Jenkins, Albany, Ga.
Curtis M. Lund	Larson Allen Weishair & Co., Minneapolis, Minn.
Benjamin F. Rose	Own Account, Hobbs, N.M.
Sandra S. Schmidt	Own Account, Boca Raton, Fla.
Melvin A. Steinberg	Bernstein and Bank Ltd., Chicago, Ill.
Chester D. Stocker	Rea & Associates, New Philadelphia, Ohio

John R. Mitchell	*Director,* Private Companies Practice Section
Barry Kuchinsky	*Manager,* Private Companies Practice Section

The following members of the 1980-81 committee contributed importantly to the Sunset Review.

Lucius A. Ashby, Jr.	Ashby Armstrong Johnson & Co., Denver, Colo.
William G. Farrow	Gallant Farrow & Greene PC, Phoenix, Ariz.
Vaughn L. Hersey, Jr.	Brooks & Carter, Bangor, Maine
William W. Kidd	Mauldin & Jenkins, Macon, Ga.